Based on the Congressional Budget Office (CBO) current policy economic forecast (contained in Chapter IV) and the budget policies of the Second Concurrent Resolution for Fiscal Year 1981, CBO estimates that the deficit would be $61.2 billion in fiscal year 1981 and $73.0 billion in fiscal year 1982. Outlays would increase by $80.7 billion (13.9 percent) in fiscal year 1981 and by $82.7 billion (12.5 percent) in fiscal year 1982. This projected growth in spending primarily reflects large increases in defense purchases and interest payments, and substantial cost-of-living adjustments for Social Security beneficiaries.

The second resolution for fiscal year 1981 was not specific about the composition of the tax cuts it contained. CBO's current policy revenue projections assume that marginal personal income tax rates will be lowered by 10 percent, effective in July 1981, and that depreciation periods for business capital investment will be shortened, retroactively to January 1981. 6/ Despite these tax cuts, total receipts would rise by $79.1 billion in fiscal 1981, and by $70.9 billion in fiscal 1982, under current policy assumptions. 7/

In regard to economic impact, discretionary changes in the current policy budget would be restrictive during 1981, and slightly stimulative in fiscal year 1982 because of the tax cut. But

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6/ These tax policy measures are estimated to reduce budget receipts by $9.1 billion in fiscal year 1981 ($6.6 billion for individuals and $2.5 billion for corporations), and by $44.9 billion in fiscal year 1982 ($34.7 billion for individuals and $10.2 billion for corporations).

7/ The windfall profits tax would generate a total of $61.9 billion in revenues during these two fiscal years. The January 1981 increases in Social Security tax rates (from 12.26 percent to 13.30 percent) and in the maximum taxable earnings base (from $25,900 to $29,700) together are estimated to add $10.8 billion to receipts in fiscal year 1981, and $19.6 billion in fiscal year 1982. The maximum taxable earnings base will be raised again on January 1, 1982, according to a formula relating it to past increases in average weekly earnings. Also, the combined employer-employee tax rate is legislated to increase slightly.

considering the combined economic effect of automatic stabilizers as well as discretionary changes in federal spending and taxes, a current policy budget would probably be stimulative in both years.

The Reagan Administration Budget Proposals

In his February 18 message to Congress, the President proposed a dramatic change in economic policies designed to slow inflation and encourage growth in productive capacity. His budgetary proposals would shift priorities from nondefense to defense spending and from federal to private-sector allocation of resources. The size of the federal sector would be reduced by sharply reducing the growth of federal spending and by cutting federal taxes for individuals and businesses. The Administration also would reduce the growth of federal credit programs. In comparison to the current policy budget, the budget proposed by the President would have a moderately restrictive effect on aggregate demand during this year and next. The tax cuts proposed by the Administration are only slightly larger than the current policy tax cuts for 1982, and they are accompanied by a large spending reduction not included in current policy.

According to the Administration's March 10 budget document, its budget program would result in deficits of $54.9 billion in fiscal year 1981 and $45.0 billion in fiscal year 1982 (see Table 14). A balanced budget is projected for 1984.

TABLE 14. PRESIDENT REAGAN'S PROPOSED BUDGET, FISCAL YEARS 1981-1984 (In billions of dollars)

	1981	1982	1983	1984
Revenues	600.3	650.3	709.2	770.7
Outlays	655.2	695.3	732.0	770.2
Percent change	13.0	6.1	5.3	5.2
Surplus or Deficit (-)	-54.9	-45.0	-22.8	0.5

SOURCE: Fiscal Year 1982 Budget Revisions, March 10, 1981.

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The Administration's budget shows a sharp reduction in the growth of spending to 6.1 percent in fiscal year 1982, approximately half the projected growth rate of current policy spending for that period. In comparison, actual spending rose at an average annual rate of 13.4 percent between fiscal years 1978 and 1980.

The tax cuts proposed by the Administration are larger than its proposed spending reductions, and would channel about 80 percent of the tax savings to individuals during the fiscal year 1982-1984 period. Personal income tax rates would be lowered by 10 percent per year over the next three years. The first cut would be made effective July 1, 1981. According to Administration estimates, this action would reduce receipts by $6.4 billion in fiscal year 1981 and by $44.2 billion in fiscal year 1982. The across-the-board reduction in marginal tax rates, which would provide larger average tax savings for high-income taxpayers, is designed to encourage savings and investment. The proportion of total taxes paid by different income groups would not be significantly altered, although the after-tax incomes of high-income taxpayers would be raised by a greater proportion.

For businesses, tax reductions would be realized through faster depreciation write-offs for business equipment and structures. The Accelerated Cost Recovery System would establish five classes of investment with different depreciation periods and schedules. 8/ Equipment would be depreciated at an accelerated rate in either three years (autos, light trucks, and machinery and equipment used in research and development activities) or five years (other types of machinery and equipment). 9/ Certain classes of structures, such as factory buildings, retail stores, and warehouses used by their owners, would qualify for accelerated depreciation over a 10-year period. Nonresidential structures not included in the 10-year class and low-income rental housing would be assigned a 15-year straight-line depreciation schedule. Other residential structures for rental, such as apartment buildings,

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8/ In large part, the Administration's proposal resembles the "10-5-3" depreciation system set forth in the Capital Cost Recovery Act of 1979.

9/ A 6 percent investment tax credit could be claimed for assets in the three-year class.

would be depreciated on a straight-line basis over an 18-year period. The Administration estimates that these faster depreciation provisions would reduce business taxes by $2.5 billion in fiscal year 1981 and by $9.7 billion in fiscal year 1982. 10/

CBO Estimates With Administration Policies

Attainment of a balanced budget by 1984 depends to a large extent on the performance of the economy. Inflation, unemployment, and the level of nominal income have major effects on federal revenues and outlays.

CBO has estimated the economic effects of the Administration's policies in the light of historical experience. CBO's analysis of the economic impact of the Administration's budget proposals is contained in Chapter V. It suggests the probability of lower real economic growth and higher inflation over the 1982-1986 period than assumed by the Administration.

All estimates of the economic effects of alternative budget policies are subject to a large margin of error, and the range of error can be wider than the differences between the economic projections of the Administration and CBO. Nevertheless, the budget implications of these different projections are important. The more pessimistic CBO projection implies sizable additional spending for indexed benefit payments, unemployment compensation, and net interest costs, which would add over $13 billion to 1982 budget outlays and over $35 billion by 1984 (see Table 15). For revenues, the differences between the projections of CBO and the Administration are slight. CBO's projection of lower real growth through 1984 is offset by higher inflation, so that the projections of nominal incomes are very close.

In addition to the differences in economic assumptions discussed above, CBO in a number of instances makes different programmatic assumptions, and uses different spending rates, from those

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10/ The provisions for the 5-, 10-, and 15-year classes would be phased in over five years. This phase-in reduces short-term revenue costs, but may result in the postponement of some investment as businesses wait for larger tax benefits.

of the Administration. CBO bases its assumed spending patterns on analyses of historical outlay trends and careful monitoring of actual outlays as they are reported monthly by the Treasury Department. Similarly, CBO's programmatic assumptions are based on its own analyses of trends in the growth of benefit populations and the utilization of federal benefits, and on other factors. As shown in Table 15, the use of these different spending rate and programmatic

TABLE 15. CBO BUDGET OUTLAY REESTIMATES OF ADMINISTRATION SPENDING PROPOSALS BASED ON ALTERNATIVE ECONOMIC ASSUMPTIONS AND OTHER FACTORS (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Alternative Economic Assumptions				
Net interest	1.2	8.1	13.3	12.5
Social Security and other indexed benefit payments	0.2	0.9	3.0	9.3
Medicare and Medicaid	---	0.1	0.7	1.6
Defense fuel costs	0.3	1.4	2.4	3.4
Unemployment compensation	-0.7	1.9	4.6	6.0
Other programs	0.2	1.1	2.4	2.8
Subtotal	1.1	13.5	26.3	35.6
Alternative Programmatic Assumptions, Spending Rates, and Other Factors				
Defense programs	0.5	5.1	2.1	7.3
Farm price supports	1.6	.8	1.0	0.7
Social Security and other income security programs	-0.1	1.8	2.6	2.7
OCS rents and royalties a/	0.9	-0.3	-1.5	-2.9
Other programs	2.5	5.3	3.5	4.2
Subtotal	5.3	12.8	7.6	12.0
Total Reestimates	6.5	26.3	33.9	47.6

a/ OCS: Outer Continental Shelf.

SOURCE: Congressional Budget Office.

assumptions result in rather sizable reestimates of the Adminstration's projected outlays. 11/

The combined effects of CBO's outlay and revenue reestimates would add $8 billion to the Administration's projected budget deficit for fiscal year 1981 and $22 billion to the 1982 deficit. The estimated 1982 deficit that would result from the Administration's fiscal policies is similar to the deficit projected by CBO under a continuation of current policies ($67 billion for the Administration's budget compared to CBO's current policy estimate of $73 billion). CBO's repricing of the Administration's budget projections for 1984 using CBO's alternative economic assumptions and estimating methods result in a projected budget deficit of almost $50 billion in 1984 instead of a small surplus (see Table 16).

TABLE 16. CBO ESTIMATES OF BUDGET TOTALS BASED ON ADMINISTRATION TAX AND SPENDING PROPOSALS (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Revenues				
Administration	600	650	709	771
CBO	599	654	707	769
Outlays				
Administration	655	695	732	770
CBO	662	721	766	818
Surplus or Deficit (-)				
Administration	-55	-45	-23	1
CBO	-63	-67	-59	-49

11/ For a detailed discussion of the Administration's budget see Congressional Budget Office, An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982, Staff Working Paper (March 1981).

CHAPTER IV. THE OUTLOOK THROUGH 1982 WITH CURRENT BUDGET POLICIES

The CBO current policy forecast shows real activity remaining relatively weak and inflation remaining quite high in 1981. Economic growth is expected to accelerate in 1982, but not as rapidly as the typical postwar recovery. A major reason for the relatively weak growth during this period is the substantial momentum of inflation in combination with the policy of the Federal Reserve to curtail the growth of the money supply.

This chapter presents the CBO economic forecast based upon the budget policies of the Second Concurrent Resolution on the Budget for Fiscal Year 1981. The impact of alternative tax and spending policies on the economy are discussed in Chapter V.

POLICY ASSUMPTIONS OF THE FORECAST

Economic forecasts are significantly affected by assumptions about fiscal and monetary policies. The policies assumed in the CBO forecast are as follows:

- Total federal government spending is $660 billion in fiscal year 1981 on a unified budget basis and $743 billion in fiscal year 1982.

- The second budget resolution for 1981 incorporated an unspecified tax cut. That tax cut is assumed to be a 10 percent reduction in personal income taxes beginning in July 1981 and a business tax reduction based on the Senate Finance Committee's proposed "2-4-7-10" accelerated depreciation, effective retroactively to January.

- The growth in money aggregates over the next two years is somewhat above the upper end of the Federal Reserve's announced target ranges.

In addition, the forecast incorporates the following assumptions about food and fuel prices:

- Consumer food prices increase by 12.3 percent in calendar year 1981 and by 11.7 percent in 1982; and

- o The international price of oil continues rising--up 28 percent from the end of 1980 to the end of 1982.

THE OUTLOOK

The CBO current policy forecast is presented in Table 17. Its major features are:

- o Growth in constant-dollar GNP is projected to rise in the 0.8 to 2.8 percent range from the fourth quarter of 1980 to the fourth quarter of 1981. Real growth is forecast to accelerate somewhat in 1982--rising by 1.8 to 3.8 percent.

- o Inflation, as measured by the implicit price deflator for GNP, is forecast to remain quite high over the next two years. Prices are forecast to rise by 9 to 11 percent during 1981 and by 8 to 10 percent during 1982.

- o The unemployment rate is likely to rise somewhat in 1981, to a range of 7.3 to 8.3 percent by the fourth quarter and then to decline slightly the next year to a range of 7.1 to 8.1 percent.

The CBO forecast expects weak economic activity this spring for many of the same reasons that the economy weakened last year. At the turn of the year, interest rates had reached new record high levels as credit demand revived with the economy, inflation remained stubbornly high, and the Federal Reserve struggled to restrain money-supply growth. Very high borrowing costs are expected to slow the economic expansion--especially by curtailing residential construction, intended inventory accumulation, business investment in new plant and equipment, state and local government capital spending, and some consumption outlays, notably for big-ticket items like appliances and automobiles. The recent decline in interest rates reflects reduced demand for credit and, along with early evidence on weaker housing starts and nondefense capital goods orders, does suggest economic growth is slowing.

In addition, the recent growth of personal income, after adjustment for inflation, has not been keeping pace with consumption spending--causing the saving rate to fall to 3.9 percent in

TABLE 17. ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1981 AND 1982, BASED ON POLICIES CONSISTENT WITH THE SECOND BUDGET RESOLUTION FOR FISCAL YEAR 1981

Economic Variable	Levels: 1980:4 (actual)	Levels: 1981:4	Levels: 1982:4	Rate of Change (percent): 1979:4 to 1980:4 (actual)	Rate of Change (percent): 1980:4 to 1981:4	Rate of Change (percent): 1981:4 to 1982:4
GNP (billions of current dollars)	2,730.6	3,004 to 3,113	3,304 to 3,549	9.4	10.0 to 14.0	10.0 to 14.0
Real GNP (billions of 1972 dollars)	1,485.6	1,498 to 1,527	1,525 to 1,585	-0.3	0.8 to 2.8	1.8 to 3.8
GNP Implicit Price Deflator (1972=100)	184	200 to 204	216 to 224	9.8	9.0 to 11.0	8.0 to 10.0
Consumer Price Index (1967=100)	257	282 to 287	306 to 317	12.5	9.7 to 11.7	8.6 to 10.6
Unemployment Rate (percent)	7.5	7.3 to 8.3	7.1 to 8.1	--	--	--

February 1981 from the 6.2 percent reached in the second quarter of 1980. That low rate and the decline in consumer confidence about the future suggest some retrenchment in personal consumption spending--especially once the automobile price rebate programs end.

Finally, many of the U.S. trading partners expect to experience slow growth--or recession--this year. As a result, export demand will likely suffer.

The projected weakness in the economy would slow the growth of private-sector credit demands, allowing interest rates to move down somewhat. This easing of financial markets, together with the assumed tax cut in July, will help set the stage for some rebound in real growth later in the year. In addition, the assumed increase in depreciation allowances is expected to boost business fixed investment. But the overall growth rate, both in late 1981 and in 1982, is expected to be modest. In large part, the problem is that inflation is forecast to remain stubbornly high; thus, with the revival of real economic activity and credit demands, interest rates would also rise and would work to curtail the growth in output.

The Persistence of Inflation and Monetary Policy

The persistence of high inflation, even during periods of slack labor and product markets, is the keystone of the current-policy forecast. The Federal Reserve is assumed to keep credit markets relatively tight in the effort to bring the inflation rate down. But the restrictive monetary policy is not forecast to achieve quick results. Postwar experience indicates that, in such circumstances, inflation comes down slowly.

The momentum of inflation is rooted in part in the assumed increases in food and energy prices, spelled out above. Other reasons for it include:

- Wage increases are projected to remain high as workers, especially in large and/or unionized firms, catch up to past increases in inflation.

- Legislated increases in payroll taxes and the minimum wage have added an estimated 0.8 percentage point to labor cost growth in 1981 and will add a small amount in 1982.

- Productivity growth is forecast to be below the postwar trend. To the extent that real wage demands remain keyed to the longer-term rate of productivity improvement, costs and prices are pushed up.

- Business profit margins, which have been very depressed recently, are projected to begin rising again late this year and continue to increase in 1982.

- The forecast does not include a typical inventory cycle; thus, the weakness is likely to result in less retail price cutting.

Risks to the Forecast

There are a number of plausible events that would change the short-term outlook substantially. Perhaps most important is the possibility that commodity prices--for food, oil, and the like--could be sharply different than assumed in the CBO current policy forecast. World commodity prices can be extremely volatile, as was demonstrated by the roughly 100 percent rise in OPEC oil prices in 1979--the reverberations from which continue to be felt. That volatility makes these prices, and consequently inflation in general, exceptionally difficult to forecast with accuracy. Indeed, a reasonable case can be made both for higher and for lower commodity prices than are assumed in the forecast.

Higher Commodity Prices. While upward price pressure could come from a variety of sources, the greatest risk comes from energy and food. If international oil prices increase more than assumed in the forecast, the most likely cause would be some supply restrictions. One such scenario has Saudi Arabia cutting back its own oil production in line with, or ahead of, increased production from Iran and Iraq. In addition, if economic growth in Europe in 1981 reaches 2 percent, instead of the 1/4 percent forecast by the Organisation for Economic Co-operation and Development (OECD), then price increases--perhaps in the neighborhood of 20 percent--could result.

There could also be larger increases in food prices than assumed in the current policy forecast. World feed grain stocks are low after the poor 1980 harvest. If the 1981-1982 crop year also results in relatively poor production, then increases in world grain prices could be very large.

Lower Commodity Prices. Although recent experience suggests that higher commodity prices are more likely than lower prices, the possibility that commodity prices may rise by less than assumed in the current policy forecast certainly cannot be ruled out. Given a glut in world oil markets, together with exceptional harvests, an optimistic scenario might show food and fuel prices rising little, if any, in the forecast period. Such a combination of fortuitous events occurred in 1976, helping to slow the rate of inflation significantly from 1975.

The Economic Impact of the Alternative Assumptions. Since world commodity prices cannot be forecast with accuracy, it is useful for policymakers to have some feel for the impact of sharp changes in commodity prices on the economic outlook. A CBO estimate of the impact on the economy of the more optimistic assumptions for food and fuel prices is summarized in Table 18.

TABLE 18. ESTIMATED IMPACT OF LOWER FOOD AND FUEL PRICES ON THE ECONOMY a/

	1982:4
Real GNP (billions of 1972 dollars)	18.0
GNP Implicit Price Deflator (percent)	-1.7
Unemployment Rate (percentage points)	-0.4

NOTE: Average results from simulations on three econometric models: Chase Econometrics, Data Resources, Inc., and Wharton Econometric Forecasting Associates.

a/ Retail food prices are assumed to be unchanged over the forecast period; world oil prices are assumed to rise at less than a 5 percent annual rate.

As shown, the optimistic scenario results not only in significantly lower prices but also in higher economic growth and reduced unemployment. This beneficial impact on the economy occurs mainly through increased purchasing power, lower interest rates, and greater efficiency in the allocation of resources.

Unfavorable price shocks would have the opposite effects. The relative impacts of the pessimistic assumptions might be roughly symmetrical to those in Table 18.

CHAPTER V. ANALYSIS OF TWO FISCAL POLICY OPTIONS

This chapter analyzes two fiscal policy options. 1/ The first is the fiscal policy proposed by the Administration on February 18, 1981. In broad outline, it contains:

- A sharp increase in defense spending, which boosts the average annual growth of defense spending in real terms to nearly 9.0 percent over the 1980 to 1986 period;

- A large reduction in nondefense spending, building from $48 billion in fiscal year 1982 to $138 billion in 1984, relative to the spending proposals in the January 1981 budget of the Carter Administration;

- Three 10 percent reductions in individual income tax rates effective July 1981, July 1982, and July 1983; and

- Much faster depreciation of business capital for income tax purposes.

The second fiscal policy option is a scaled-down version of the first. It proposes:

- Slightly lower growth in defense spending than proposed by the Administration;

- Smaller nondefense spending cuts (about 70 percent of the first package);

- The same size individual income tax cuts, but phased in over a longer period; and

- A smaller depreciation reform.

The Congressional Budget Office has estimated how the economy would respond to these policies in comparison with a baseline

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1/ The Senate Budget Committee requested the analysis of these two fiscal policy options.

forecast assuming the continuation of current policies (described in Chapter IV). Estimates of this sort are always difficult to make. The course of the economy, even without policy changes, cannot be predicted with a high degree of reliability, and the effects of policy changes are subject to even more uncertainty. Forecasting the effect of these changes is particularly difficult for at least two reasons:

- The unusual economic conditions at this time--a sustained high level of inflation together with high unemployment, relatively low capacity utilization, and record high interest rates--have raised some questions about using historical experience as a guide to the future; and

- The policy changes under consideration, particularly the multiyear cut in personal income taxes, are unusually large.

Hence, the estimates presented below are subject to a large margin of error. An initial estimate of the effect of each policy option is made here--based on historical experience--followed by a discussion of factors that might alter those estimates.

ANALYSIS OF THE TWO FISCAL POLICY OPTIONS

The systematic analysis of the economic effects of alternative fiscal policies requires a model of how the economy works. 2/ The outcome of such an analysis depends on four factors: the nature of the model; the degree to which it corresponds to the actual behavior of the economy; an estimate of how the economy would behave absent the policy change--the baseline economic projection; and the specification of the policy change--its size, timing, and other significant characteristics.

2/ The model used does not have to be empirical in nature (where the various responses by households, firms, and governments to economic change are quantified on the basis of previous experience and/or surveys of intentions). It can, instead, be wholly abstract. Since economic theory tends to say more about the direction of a response than its size, however, abstract models typically cannot provide specific forecasts of the economy under alternative fiscal policies. For that, an empirical model is needed.

The CBO Five-Year Projection

The baseline economic path used in the analysis of the two fiscal policy options is the CBO five-year economic projection. For 1981 and 1982, that projection is CBO's current policy forecast of economic activity--which assumes the continuation of the tax and spending policies of the Second Concurrent Resolution on the Budget for Fiscal Year 1981. This two-year forecast is presented in detail in Chapter IV.

For 1983 through 1986, the CBO projection assumes a moderate growth of real nonfederal spending and productive capacity, which on the basis of postwar experience implies tax cuts sufficient to prevent a rise in effective tax rates resulting from the interaction of the progressive tax system and rising nominal incomes. The additional and unspecified tax reductions in the baseline projection total about $30 billion in 1983, rising to roughly $110 billion by 1986 (see Table 19). Without these further tax adjustments, the rising tax burden would probably slow economic activity substantially.

TABLE 19. TAX REDUCTIONS IMPLICIT IN THE CBO FIVE-YEAR PROJECTION (By calendar year, in billions of dollars, on an NIA basis)

	1981	1982	1983	1984	1985	1986
Specified Tax Cuts	-20	-47	-55	-64	-74	-85
Unspecified Tax Cuts	0	0	-30	-50	-80	-110
Total	-20	-47	-85	-114	-154	-195

Specification of the Administration Policy Option

The estimates of the year-by-year direct budget costs (National Income Accounts basis) of the Administration's policy proposal used in the CBO analysis are presented in Table 20. The total reduction in nondefense spending amounts to $46 billion

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TABLE 20. CHANGES IN SPENDING AND REVENUES UNDERLYING THE FIRST POLICY OPTION (By calendar year, in billions of dollars, on an NIA basis)

	1981	1982	1983	1984	1985	1986
Expenditure Changes						
Nondefense	-9	-46	-76	-96	-105	-109
Defense	2	6	18	25	48	57
Total	-7	-40	-58	-71	-57	-52
Revenue Changes						
Roth-Kemp Tax Cut	-15	-49	-93	-130	-153	-179
10-5-3 Allowances	-6	-15	-25	-35	-47	-57
Total	-21	-64	-118	-165	-200	-236

in calendar year 1982, increasing to nearly $100 billion by calendar year 1984, as compared to spending under current law. The increase in defense spending builds from $6 billion in 1982 to $25 billion in 1984.

The estimated static revenue losses from the personal income tax cut and from the increase in depreciation allowances are also shown in Table 20. 3/ These estimates are relative to a baseline without tax cuts.

Estimates of the Economic Impact of the Administration's Budget Proposals--Based on Historical Experience

Economists have developed several large-scale econometric models based on the history of the U.S. economy since World War

3/ Static revenue estimates include no feedback effects on revenues from the economic impact of the changes.

II. These models can be used to answer the question: What does past experience tell us about the likely effect of a given policy change? Since the models differ in structure, they tend to give somewhat different answers. CBO has developed techniques for averaging their results. 4/

The CBO projection incorporating the Administration's budget policies (referred to as the CBO alternative) indicates that the effects of the Administration's proposed budget changes on gross national product, inflation, unemployment, and interest rates would not be greatly different from the CBO five-year baseline projection (see Table 21). This is because the net effects of the fiscal policies in each are similar. The CBO five-year projection has assumed tax cuts that are smaller than those specified in the Administration's proposals, but the Administration assumes net spending cuts not present in the CBO projection.

Relative to a baseline with no tax cuts, the Administration's proposals would significantly increase real economic growth and lower the unemployment rate while causing some upward push on inflation in the out-years. The delayed inflationary impact of the personal income tax cut would be curtailed by spending cuts and by the increases in productive capacity in later years resulting largely from the cuts in business taxes.

Specification and Estimation of the Second Option

The second fiscal policy option to be examined assumes substantially smaller nondefense spending cuts (about 70 percent as large as those proposed by the Administration) and defense increases that are about three-fourths as large as those in the Administration program. In addition, the second package assumes the same personal income tax cuts as the Administration proposal, but phased in over a longer period, and a smaller adjustment in depreciation allowances (see Table 22).

The effects of the second fiscal policy option, relative to the CBO five-year projection, are smaller, although they show a

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4/ See Congressional Budget Office, The Multipliers Project: A Methodology for Analyzing the Effects of Alternative Economic Policies (August 1977).

TABLE 21. ESTIMATES OF THE EFFECTS OF THE ADMINISTRATION'S BUDGET CHANGES COMPARED WITH THE CBO FIVE-YEAR PROJECTION (By calendar year)

	1981	1982	1983	1984	1985	1986
GNP (percent change, year over year)						
CBO Alternative a/	11.8	11.9	11.5	11.4	11.7	10.9
CBO Five-Year Projection	11.9	12.3	11.8	11.7	11.2	10.8
Real GNP (percent change, year over year)						
CBO Alternative a/	1.3	2.5	2.7	3.0	3.8	3.7
CBO Five-Year Projection	1.4	2.9	2.9	3.3	3.4	3.5
GNP Deflator (percent change, year over year)						
CBO Alternative a/	10.3	9.2	8.6	8.1	7.5	7.0
CBO Five-Year Projection	10.3	9.2	8.6	8.1	7.6	7.1
CPI (percent change, year over year)						
CBO Alternative a/	11.3	9.5	8.9	8.2	7.7	7.1
CBO Five-Year Projection	11.3	9.5	9.0	8.3	7.7	7.2
Unemployment Rate (percent, annual average)						
CBO Alternative a/	7.8	7.9	7.8	7.7	7.5	7.2
CBO Five-Year Projection	7.7	7.6	7.5	7.4	7.2	7.0
Three-Month Treasury Bills (percent, annual average)						
CBO Alternative a/	12.6	13.7	11.5	10.2	9.7	9.3
CBO Five-Year Projection	12.7	13.8	11.6	10.3	9.8	9.6

NOTE: The CBO current policy forecast in Chapter IV reflects the recently revised GNP data for 1980. These revisions have not been incorporated here.

a/ The CBO alternative projection was derived by removing from the current-policy baseline all tax changes not already legislated, and then incorporating the effects of the fiscal policy changes proposed by the Administration.